JOHN A. BIEK is a Partner in the Tax Practice Group of Neal, Gerber & Eisenberg LLP in Chicago, Illinois.

State Law & State Taxation Corner

State Resident Tax Credits Don't Always Apply to Taxes Paid to Another State on Passthrough Entity Income

By John A. Biek*

Introduction

States generally apply their personal income tax to the entire income of a resident individual, wherever that income was earned, as states are allowed do under the Due Process Clause of the U.S. Constitution.[1] In order to avoid potential double taxation of that income, states then provide a credit to the resident individual for taxes that he or she paid to another state on income that the state of residence is also taxing. In an ideal world, this resident tax credit would apply to the entire amount of tax that the resident individual paid to the nonresident state where the income was earned, and the aggregate state tax payments of the resident (net of the credit) would not exceed the amount of tax liability the resident would have owed to the state of residence if all of the income had been earned in that state. This is usually the case if the nonresident state's tax rate is not higher than the tax rate of the resident state, as the amount of the resident tax credit is typically limited to the amount of tax liability the resident state is imposing on the double-taxed income.

However, two recent cases from Maine and New Jersey, *Goggin v. State Tax Assessor*[2] and *Doherty v. Director, Division of Taxation*,[3] respectively, illustrate further limitations on resident tax credits in the passthrough entity context, specifically (1) where the income tax of the nonresident state has been imposed on and paid by the passthrough entity (as opposed to the nonresident owner of the passthrough entity) and (2) where the resident state's income tax law treats the passthrough entity as having earned a smaller amount of income in the nonresident state than that state's income tax law provides. These cases serve as a helpful reminder that owners of passthrough entities should not blithely assume that they will be provided a resident tax credit for the entire amount of taxes that have been paid to other states on the owner's distributive share of the income of the passthrough entity.

The *Goggin* Case

James and Ann Goggin were residents of Maine during the 2012–2014 tax years at issue in their case.[4] Ann owned a membership interest in GHK Company, LLC

("GHK"), a New Hampshire limited liability company engaged in a real estate development business in New Hampshire.[5] GHK was classified as a partnership for federal and Maine income tax purposes, with the result that Ann's distributive share of the New Hampshire-source rental income of GHK flowed through to the Goggins' federal and Maine tax returns.[6]

New Hampshire does not have a broad-based personal income tax, only taxing individuals on interest and dividend income. However, New Hampshire does have two entity-level business taxes that it imposed on GHK during the 2012–2014 tax years. The New Hampshire business profits tax was imposed at a rate of 8.5 percent on the taxable business profits of every business organization, including an LLC or partnership, doing business in the state.[7] The New Hampshire business enterprise tax was imposed at a rate on 0.75 percent of the "taxable enterprise value tax base" (defined as the sum of all compensation, interest and dividends paid or accrued) of every business enterprise, again including an LLC or partnership.[8] GHK deducted its payments of New Hampshire business profits tax and business enterprise tax as business expenses on its federal partnership tax return (Form 1065), and the federal and Maine Schedule K-1s that Ann Goggin received from GHK reported her distributive share of the rental income of GHK net of the expense of these entity-level New Hampshire taxes imposed on the LLC.[9]

However, two recent cases from Maine and New Jersey, Goggin v. State Tax Assessor *and* Doherty v. Director, Division of Taxation, *respectively, illustrate further limitations on resident tax credits in the passthrough entity context, …*

For each of the 2012–2014 tax years, the Goggins filed joint federal and Maine income tax returns that included Ann's distributive share of the rental income of GHK reduced by the New Hampshire business profits tax and business enterprise tax payments by GHK.[10] As a resident of Maine, Ann was subject to Maine personal income tax on the entire amount of her distributive share even though GHK had earned that rental income from its business operations in New Hampshire.

In January 2016, the Goggins filed amended Maine income tax returns for the 2012–2014 tax years that claimed the resident tax credit for Ann's *pro rata* share of GHK's payments of the two entity-level New Hampshire business taxes. The Maine resident tax credit statute provided that:

> A resident individual is allowed a credit against the tax otherwise due under this Part, excluding the tax imposed by [the alternative minimum tax], for the amount of *income tax imposed on that individual* for the taxable year by another state of the United States, a political subdivision of any such state, the District of Columbia or any political subdivision of a foreign country that is analogous to a state of the United States with respect to income subject to tax under this Part that is derived from sources in that taxing jurisdiction.[11]

These amended returns claimed refunds of the resulting overpayments of Maine personal income tax by the Goggins.[12]

Curiously, the Goggins' amended Maine tax returns did not increase Ann's distributive share of GHK income by the amount of New Hampshire business profits tax and business enterprise tax expenses that GHK had deducted from its ordinary business income flowing through to Ann. As a result, the Goggins' amended Maine tax returns claimed the double tax benefit of both a deduction and a credit for GHK's New Hampshire business entity tax payments.[13]

Maine Revenue Services denied the Goggins' refund claims, and the Maine Superior Court affirmed that decision, because the New Hampshire business taxes had been imposed *on GHK*, not on its members. As a result, those business taxes could not be treated as an "amount of income tax imposed on [an] individual," as required by the language of the Maine resident tax credit statute.[14] The Goggins appealed to the Maine Supreme Judicial Court, arguing that "the business taxes imposed on the LLC are functionally income taxes on the individual holders because of the 'flow through' nature of income realized by an LLC." The Goggins claimed that the Superior Court's "formalistic interpretation of the statute resulted in the 'double taxation' of Maine entrepreneurs."[15]

The Maine Supreme Judicial Court affirmed, holding that the Goggins' argument was belied by the language of the Maine resident tax credit statute:

> The plain meaning of an "income tax imposed on [an] individual" excludes taxes that are imposed on,

> and paid by, business entities. 36 M.R.S. §5217-A. Unlike in the cases in some other jurisdictions in which an out-of-state tax was held to generate a credit, the New Hampshire business taxes imposed here were not taxes imposed on individuals for *unincorporated* businesses. *Cf. District of Columbia v. Califano,* 647 A.2d 761, 765 (D.C. 1994) (holding, in concluding that an individual was entitled to a credit for paying an unincorporated business tax, that the "term 'individual income tax' cannot rationally denote anything other than income tax paid by an individual"); *Mathy v. Commonwealth Department of Taxation,* 263 Va. 356, 483 S.E.2d 802, 802-04 (Va. 1997) (holding that the District of Columbia's unincorporated business tax is a tax on income). Rather, the New Hampshire taxes were imposed on the LLC's statutorily defined "taxable business profits," N.H. Rev. Stat. Ann. §§77-A:1(IV), 77-A:2, 77-A:4 (2012), and the "taxable enterprise value tax base of [a] business enterprise," N.H. Rev. Stat. Ann. §§77-E:1(III), (IX), 77-E:2 (2012).[16]

The Maine Supreme Judicial Court noted that, if the Maine statute provided a credit for all taxes "on income," as the Vermont resident tax credit provision did in *Tarrant v. Department of Taxation*,[17] the court might have allowed the Goggins to claim a credit for Ann's *pro rata* share of the New Hampshire business entity taxes paid by GHK. But the Maine Supreme Judicial Court was dealing with a Maine statute that expressly limited the resident tax credit to "income taxes paid by individuals on income derived from other states." The Maine Supreme Judicial Court felt compelled to hold that this phrase did not encompass the business taxes that GHK had paid to New Hampshire on its own taxable business profits and taxable enterprise value tax base.[18]

The Maine Supreme Judicial Court also criticized the Goggins for claiming a double tax benefit for the New Hampshire business entity tax payments by GHK:

> The Goggins did, as they acknowledge, realize some tax benefit due to the exclusion of a portion of the LLC's income expended on New Hampshire business taxes from the amount of the Goggins' federal adjusted gross income for each of the tax years in question. If the tax credit were also applied as the Goggins suggest, it would result in a small windfall to them: they would enjoy both the deduction from their adjusted gross income of a proportionate amount of New Hampshire business taxes paid by the LLC *and* a credit for a proportionate share of the taxes that the LLC paid to New Hampshire.[19]

Having determined that the language of the Maine resident tax credit statute did not allow the Goggins to claim the credit for these New Hampshire business entity taxes imposed on GHK, the Maine Supreme Judicial Court went on to hold that this limitation on the resident tax credit did not violate the Commerce Clause. In *Comptroller of Treasury of Maryland v. Wynne*,[20] the U.S. Supreme Court held that Maryland violated the internal consistency test of the Commerce Clause by not providing Maryland residents a credit against their Maryland county income tax liability for income taxes the resident had paid to other states on the income that was being subjected to the Maryland county income tax. The Supreme Court determined in the *Wynne* case that Maryland residents who earned all their income from sources in Maryland would pay less overall state and county income tax in Maryland than would a Maryland resident who earned the same amount of income in another state and did not receive a credit against his Maryland county income tax for the taxes he paid to the other state and its county on that double- taxed income.

The Goggin *and* Doherty *cases are useful reminders to owners of passthrough entities that they may not be allowed to claim a resident tax credit for all of the taxes paid to other states with respect to their distributive share of the passthrough entity's income from its multistate business operations.*

The Maine Supreme Judicial Court held in the *Goggin* case, however, that the internal consistency test analysis in the *Wynne* case did not lead to the same conclusion when the tax was imposed by the nonresident state *on a different taxpayer* than the taxpayer who was claiming the credit so as to avoid "double taxation" of the taxpayer's income. The Maine court explained that:

> [N]either the Supreme Court nor we have held that an individual must receive credit for taxes imposed on a *business entity* formed in another state by the taxing

> authority of that state. The types of state business taxes that are treated as state income taxes are those that are actually imposed on individuals rather than on entities.[21]

The Maine Supreme Judicial Court concluded that "[a]lthough New Hampshire's taxation scheme may create a disincentive to form such entities in New Hampshire, it is not the application of Maine's tax laws that creates that result. Maine's income tax credit statute, 36 M.R.S. §5217-A, satisfies the internal consistency test."[22]

The *Doherty* Case

Whereas the LLC member was denied the Maine resident tax credit in the *Goggin* case because a different taxpayer (*i.e.*, the LLC) was subject to the New Hampshire business entity taxes for which the Maine resident member was claiming the Maine tax credit, in *Doherty v. Director, Division of Taxation*,[23] S corporation shareholders were denied the portion of the New Jersey resident tax credit that they were claiming for Pennsylvania personal income taxes the shareholders had paid on S corporation income that was not considered to have been earned in Pennsylvania under the New Jersey income tax laws.

James and Patricia Doherty were residents of Moorestown, New Jersey, during the 2011–2013 tax years at issue in the *Doherty* case.[24] This married couple were shareholders of a family business, David Weber Company, Inc., which manufactured corrugated boxes at a facility in Philadelphia, Pennsylvania.[25] The company was incorporated in Pennsylvania and had elected S corporation status for federal and state income tax purposes.[26]

As nonresidents of Pennsylvania, the Dohertys filed Pennsylvania personal income tax returns that reported only their income from sources in Pennsylvania, here their *pro rata* shares of the Pennsylvania-apportioned income of David Weber Company. In the 2012 tax year, the Dohertys' combined distributive shares of the S corporation's ordinary business income, as modified by the provisions of the Pennsylvania corporation income tax statutes, amounted to $2,252,820.[27] The S corporation had a Pennsylvania apportionment factor of 81.7087 percent, as determined by the provisions of the Pennsylvania corporation income tax statutes. This resulted in 81.7087 percent of the $2,252,280 of distributive shares, or $1,840,750, being taxed by Pennsylvania.[28] The Dohertys paid $56,511 of Pennsylvania personal income tax, at a flat rate of 3.07 percent, on their distributive shares of David Weber Company income in the 2012 tax year.[29]

As residents of New Jersey, the Dohertys were subject to New Jersey gross income tax on their entire distributive shares of the ordinary business income of David Weber Company. In the 2012 tax year, the Dohertys' combined distributive shares, as modified by provisions of the New Jersey corporation business tax statutes, amounted to $2,108,894, which was slightly less than the Pennsylvania amount of their distributive shares for that tax year.[30] However, the New Jersey corporation business tax statutes provided a markedly different apportionment formula than the Pennsylvania corporate income tax statutes did. According to New Jersey law, David Weber Company had a Pennsylvania apportionment factor of only 69.5464 percent (as opposed to the 81.7087 percent factor determined under Pennsylvania law) and a New Jersey apportionment factor of 30.4536 percent.[31] The bottom line of all these numbers was that the New Jersey Division of Taxation considered the Dohertys' distributive shares of Pennsylvania-apportioned income of David Weber Company to amount to only $1,466,660 in the 2012 tax year rather than the $1,840,750 of income that the Dohertys had reported and paid tax on to Pennsylvania in the 2012 tax year.[32]

To avoid double taxation, the New Jersey gross income tax statutes provided that:

> (a) A resident taxpayer shall be allowed a credit against the tax otherwise due under this act for the amount of any income tax or wage tax imposed for the taxable year by another state of the United States or political subdivision of such state, or by the District of Columbia, *with respect to income which is also subject to tax under this act.*[33]

In *Stiber v. Director, Division of Taxation*, the New Jersey Tax Court concluded that the language of this New Jersey resident tax credit provision "clearly restricts the credit to foreign taxed income which is also taxed by New Jersey."[34]

In 1993, as part of New Jersey's adoption of passthrough entity tax treatment for S corporations, a subsection (c) was added to the New Jersey resident tax credit statute specifying that:

> (c) No credit shall be allowed against the tax otherwise due under this act for the amount of any income tax or wage tax imposed for the taxable year on S corporation income allocated to this state.[35]

Applying these rules, the New Jersey Division of Taxation limited the Dohertys' New Jersey resident tax credit in the 2012 tax year to the $45,026 of Pennsylvania personal income tax, at its flat rate of 3.07 percent, that the Dohertys would have paid on the $1,466,660 of distributive shares of Pennsylvania-apportioned income of David Weber Company that the New Jersey corporation business tax rules apportioned to Pennsylvania.[36] It was this $1,466,660 of S corporation income that the Division of Taxation viewed as being "subject to tax" in both Pennsylvania and New Jersey. The Dohertys, of course, had claimed their entire $56,511 of Pennsylvania personal income tax payment as a resident credit on their 2012 New Jersey gross income tax return.

The New Jersey Tax Court affirmed the Division's limitation of the Dohertys' New Jersey resident tax credit amount as being consistent with subsection (a) of the New Jersey resident tax credit statute, which "describes the credit being available 'with respect to income which is also subject to tax' in New Jersey."[37] The court concluded that using the New Jersey corporation business tax apportionment rules to determine how much of the Doherty's distributive shares of the David Weber Company was being subject to income tax in both Pennsylvania and New Jersey was consistent with the intent of the New Jersey legislature "not to allow a foreign tax credit on income earned in New Jersey."[38] The court observed:

> [T]axpayers here want the court to ignore the allocation provisions of New Jersey law and instead apply the provisions of Pennsylvania law. In essence, taxpayers want a credit for all taxes paid to Pennsylvania, regardless of the allocation under New Jersey law. The problem with taxpayer's approach is that it presumes that Pennsylvania's allocation of income must be accepted despite the New Jersey Legislature specifically determining otherwise. In a broader sense, the taxpayers want New Jersey to cede its method of income allocation to that of another jurisdiction.[39]

More to the point, the New Jersey Tax Court explained:

> The plain language of subsection (c) indicates that there shall be no credit as it pertains to "S corporation income allocated to this State." N.J.S.A. 54A:4-1(c). "S corporation income allocated to this State" is a defined term which means the portion of S corporation income that is allocated to New Jersey pursuant to the allocation factor set forth in New Jersey Corporation Business Tax (CBT) Act, sections 6 through 10. N.J.S.A. 54A:5-10. *See also* N.J.S.A. 54:10A-6 to -10. Applying the allocation formula as defined by the CBT results in 30.4536% or $642,234 of the corporation income being allocated to New Jersey and 69.5464% or $1,466,660 allocated to Pennsylvania.[40]

The key point, according to the New Jersey Tax Court, was that "Subsections (a) and (c) focus on the amount of income subject to tax."[41] Because the New Jersey corporate business tax statutes apportioned $1,466,660 (or 69.5464 percent) of the Dohertys' distributive shares of David Weber Company income to Pennsylvania and $642,234 (or 30.4536 percent) of the distributive shares to New Jersey, the New Jersey resident tax credit was available only with respect to the amount of Pennsylvania personal income tax due on the $1,466,660 of income that was being taxed by both states, as determined by the New Jersey corporation business tax statutes. Subsection (c) of the New Jersey resident tax credit statute clearly prohibited the Dohertys from claiming the New Jersey resident tax credit on the Pennsylvania personal income tax that the Dohertys had paid on the other $642,234 of the distributive shares that was apportioned to New Jersey under the New Jersey corporate business tax statutes.

Conclusion

The Maine Supreme Judicial Court correctly decided the *Goggin* case. The New Hampshire business profits tax was measured by the income of the LLC, but that tax was clearly imposed on the LLC as an expense of the business operations in New Hampshire. This was not a tax on the income flowing through to the LLC's members. The LLC deducted its business profits tax and business enterprise tax payments as it would property taxes, unemployment taxes and other operating expenses of its real estate development business. These tax payments by the LLC did not represent an "income tax imposed on [an] individual" that could have qualified for the resident tax credit pursuant to the language of the Maine resident tax credit statute. It did not help, of course, that the Goggins were caught double dipping by claiming a credit for business entity taxes that already had reduced the amount of the distributive share of LLC ordinary business income flowing through to the Goggins' federal and Maine personal income tax returns.

The holding of the New Jersey Tax Court in the *Doherty* case may appear unfair because the Dohertys paid the full amount of personal income tax on their distributive shares of S corporation income that the Pennsylvania law required. New Jersey was also taxing the entire amount of those distributive shares as the state of residence of the Dohertys. But the wording of the New Jersey resident tax credit statute clearly did not allow the credit for income taxes that the Dohertys paid to another state (*e.g.*, Pennsylvania) on income of the S corporation that was apportioned to New Jersey. It was unfortunate for the Dohertys that New Jersey utilized a different apportionment formula than Pennsylvania did and that the New Jersey rules apportioned more of the S corporation's income to New Jersey than the Pennsylvania rules did. As a constitutional matter, however, New Jersey was probably allowed to use its own apportionment rules to determine the amount of the S corporation income that was being taxed in both Pennsylvania and New Jersey. There was no Commerce Clause violation because, if Pennsylvania and the other states had utilized the same apportionment formula that New Jersey does, the amount of the Dohertys' New Jersey resident tax credit would have matched the amount of the Pennsylvania personal income tax payment, and there would have been no double taxation of the Dohertys' distributive shares of S corporation income.

The *Goggin* and *Doherty* cases are useful reminders to owners of passthrough entities that they may not be allowed to claim a resident tax credit for all of the taxes paid to other states with respect to their distributive share of the passthrough entity's income from its multistate business operations.

ENDNOTES

* The author can be reached at *jbiek@nge.com*.

1 *See Shaffer v. Carter*, SCt, 252 US 37 (1920) ("[a]s to residents [the State] may, and does, exert its taxing power over their income from all sources, whether within or without the State"). *See also Lawrence v. State Tax Commission*, SCt, 286 US 276 (1932); *New York ex rel. Cohn v. Graves*, SCt, 300 US 308, 312–313, 57 SCt 466 (1937); *Oklahoma Tax Commission v. Chickasaw Nation*, SCt, 515 US 450, 463, 115 SCt 2214 (1995).

2 *Goggin v. State Tax Assessor*, 191 A3d 341 (Me. 2018).

3 *Doherty v. Director, Division of Taxation*, 30 N.J. Tax 570 (Tax 2018).

4 *Goggin*, slip op. at 2.

5 *Id.*

6 *Id.*

7 N.H. Rev. Stat. Ann. §§77-A:1 and 77-A:2(I).

8 N.H. Rev. Stat. Ann. §§77-E:1 (III and IX) and 77-E-2(I).

9 *Goggin*, slip op. at 3.

10 *Id.*, at 3–4.

11 Me. Rev. Stat., tit. 36, §5217-A (emphasis added).

12 *Goggin*, slip op. at 4.

13 *Id.*

14 *Id.*, at 5.

15 *Id.*

16 *Id.*, slip op. at 8–9 (emphasis in original).

17 *Tarrant v. Department of Taxation*, 169 Vt. 189, 733 A2d 733 (1999).

18 *Goggin*, slip op. at 9.

19 *Id.*, slip op. at 9–10 (emphasis in original).

20 *Comptroller of Treasury of Maryland v. Wynne*, SCt, 575 US _____, 135 SCt 1787 (2015).

21 *Goggin*, slip op. at 13.

22 *Id.*, slip op. at 14.

23 *Doherty v. Division, Director of Taxation,* 30 N.J. Tax 570 (Tax 2018).

24 *Id.*, at 573.

25 *Id.*

26 *Id.*, at 574.

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.*

31 *Id.*, at 575.

32 *Id.*

33 N.J. Rev. Stat. §54A:4-1(a) (emphasis added).

34 *Stiber v. Director, Division of Taxation*, 9 N.J. Tax 623, 627 (Tax 1988).

35 N.J. Rev. Stat. §54A:4-1(c).

36 *Doherty*, 30 N.J. Tax at 575.

37 *Id.*, at 580.

38 *Id.*, slip op. at 583 (*citing Criticare, Inc. v. Director, Division of Taxation*, 28 N.J. Tax 169, 179 (Tax 2014).

39 *Doherty*, 30 N.J. Tax at 586.

40 *Id.*, at 581.

41 *Id.*